UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-17342

In the Matter of

RD LEGAL CAPITAL, LLC and
RONI DERSOVITZ

PRETRIAL BRIEF OF RD LEGAL CAPITAL, LLC AND RONI DERSOVITZ

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INTRODUCTION

This is a case that never should have been brought. RD Legal Capital, LLC and Roni Dersovitz ("Respondents") manage two private funds that have delivered double-digit returns to their investors every year since their formation in 2007. Rather than investors having *lost* money, the investors in Respondents' funds have preserved their principal and realized significant gains. By any measure, the performance of the funds has been exceptional and has outpaced all benchmark indices. Respondents achieved these results through executing the same basic investment strategy—discounting future cash flows on receivables in the legal industry—which was expressly described to investors in the funds' offering documents. Stated differently, Respondents invested the money they received from investors in the very manner described to those investors in the offering documents, and by so doing delivered the above-market returns the investors hoped they would achieve. This hardly presents the picture of fraud.

Yet, against this backdrop, where no investors actually suffered harm, the Division attempts to stitch together a case of fraud. The Division's case focuses to an unusual degree on simple marketing materials and tries to parse out isolated words from those materials while ignoring both the overall text of the documents and the "total mix" of information that was made available to investors (all of whom were accredited and sophisticated). By bringing these claims, the Division also wholly ignores the actual language in the offering documents themselves, thereby turning the securities laws on their head. As will be shown at the hearing, the Division's case at its core lacks substance or proof.

At trial, the Court will hear evidence that defeats any suggestion that Respondents misled investors or somehow engaged in fraud. This includes that:

- Respondents consistently followed a single investment strategy—purchasing discounted cash flows on legal receivables—that was repeatedly disclosed to investors throughout the life of the funds;
- The offering documents for the funds expressly authorized Respondents to invest in the type of receivables they acquired on behalf of the funds, and investors were expressly advised that the funds would invest in receivables deriving from litigation, judgments, and settlements;
- To value the funds' assets, Respondents employed a nationally-recognized third-party valuation agent to recommend portfolio values each month, and Respondents marked the portfolio to the monthly values the independent agent assigned;
- The independent auditor for the funds also tested Respondents' valuation procedures as part of its annual audit and consistently found the valuation procedures met appropriate standards; and
- A large portion of the assets in the funds have now collected at, or even above, the values they had been assigned, yielding significant gains for investors and providing empiric proof that the assumptions made to value those assets were not only "reasonable" but highly accurate.

In the end, this is a case about rich, sophisticated investors who got even richer as a result of their investments in Respondents' funds, all during a time when, ironically, Mr. Dersovitz has been forced to fund the management of the business out of his own personal assets—keeping his employees employed and his investors protected, all at a significant cost to himself.

BACKGROUND

I. HISTORY OF RD LEGAL

Mr. Dersovitz practiced law in New York for 14 years. Over that time, he witnessed the challenges many attorneys and law firms faced in managing cash flow. These challenges were often the most acute for personal injury lawyers with contingency fee-based caseloads. In many of these cases, several years could pass from the time when attorneys were engaged until the close of the proceeding when funds were disbursed and the attorneys received their legal fees.

This extended timeline created an unusually long working capital cycle for those law firms, even when they had a strong portfolio of cases.

The challenge of managing cash flow at these law firms is compounded by the fact that the most valuable assets those firms often hold—their right to future legal fees from the settlement agreements and judgments they have secured for their clients—are not recognized as collateral by banks. Traditional forms of financing thus provide limited options for attorneys in this space.

Understanding this need, in 1996 Mr. Dersovitz began using his personal assets to factor law firm receivables and provide a source of funding for contingency fee-based law firms. He quickly discovered there was a significant demand for this type of financing. Accordingly, Mr. Dersovitz formed RD Legal Funding, LLC ("RDLF") in 1998 to identify, originate, and purchase legal receivables. RDLF grew quickly, and Mr. Dersovitz dissolved his law practice in 2001 and focused on legal financing full time.

Since its formation, RDLF has funded and successfully collected over $380 million spread over more than 2,300 positions originated from attorneys and plaintiffs.

The Investor Funds

With the growth and success of RDLF, Mr. Dersovitz decided to create two private funds to raise capital to take better advantage of the deep capacity in this market. In September 2007, Mr. Dersovitz launched RD Legal Funding Partners, LP, a Delaware limited partnership (the "Domestic Fund"), and RD Legal Funding Offshore Fund, Ltd., a Cayman Islands exempted company (the "Offshore Fund"). Both the Domestic Fund and the Offshore Fund (collectively, the "Funds") follow the same investment strategy. As described in the offering documents, the Funds seek to generate stable returns for investors, while maintaining capital, through:

(a) purchasing from law firms receivables representing legal fees owed; (b) purchasing from plaintiffs receivables representing proceeds from legal awards or settlements; (c) providing loans to law firms through secured lines of credit; and (d) providing capital to law firms to pursue certain other opportunities that do not fall within the categories above.

The structure of the Funds differs from most traditional hedge funds. There is no management fee. There is no performance fee. The Funds do not follow any version of a 2-and-20 model. Instead, the manager of the Funds only receives a return after all investors in the Funds receive their full targeted cumulative return of 13.5% per annum. In this model, the interests of the manager are tied to those of the investors.

The performance of the Funds has been nothing short of extraordinary. From 2007 through the present, all investors in the Domestic Fund have earned their full targeted return of 13.5% per annum. Fully participating investors in the Offshore Fund earned a return of 13.5% from 2007 through 2014, and an average return of 11.4% in 2015.[1] Even during the financial crisis, when the capital markets saw historic downturns and many alternative investment funds marked significant losses, the investors in Respondents' Funds realized double-digit gains.

RD Legal Capital

RD Legal Capital, LLC ("RDLC") is the investment manager of the Funds. Mr. Dersovitz is the President of RDLC and serves as its Chief Investment Officer.

At the end of each month, the net profits and losses of the Funds, including realized and unrealized gains and losses, are allocated to the accounts of the limited partners.[2] Any net profits

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1. The investment manager decided to close the Offshore Fund in 2015, and that fund is being wound down.

2. While investors in the Domestic Fund are limited partners and investors in the Offshore Fund are shareholders under the respective offering documents, there is not a meaningful distinction for purposes of this submission. We will refer to all investors as "limited partners" in this discussion.

in excess of the targeted 13.5% cumulative investor return are allocated to the capital account of the investment manager. This is the only income RDLC receives from the Funds.

The return to investors in the Funds is cumulative. Thus, if an investor fails to receive his or her full return in any given month, the entire amount of that shortfall is reserved and all future net profits are allocated to the capital accounts of that investor. Until all such cumulative shortfalls are satisfied, RDLC receives nothing.

Expenses of Operating the Funds

The success of the Funds was the result of the significant management efforts of Mr. Dersovitz and RDLC, but these did not come without cost. As investment manager, RDLC is responsible for all general operating expenses of the Funds. These include employee payroll and payroll taxes, consultant fees, rent, health insurance, information technology, depreciation, interest, lien search fees, accounting, utilities, and bank charges. As shown in the table below, from 2012 (the first full year covered in the OIP) through 2016, RDLC sustained net losses in excess of $4.4 million in connection with its management of the Funds:

Net Income of RD Legal Capital LLC
from Operation of Funds, 2012-2016

Year		Revenue		Expenses		Income
2012	$	8,617,771	$	6,814,224	$	1,803,547
2013	$	13,690,566	$	10,481,576	$	3,208,990
2014	$	14,984,472	$	10,051,088	$	4,933,384
2015	$	3,022,177	$	10,189,481	$	(7,167,304)
2016	$	-	$	7,216,323	$	(7,216,323)
NET	**$**	**40,314,986**	**$**	**44,752,692**	**$**	**(4,437,706.00)**

Similarly, the net draw to Mr. Dersovitz for his work in running the Funds has gone negative in recent years. Since 2014, his net draw has been *negative* $8.3 million—meaning he has put more than $8 million of his own capital back into the business to pay his employees, maintain investor relations, secure the portfolio assets, and generally ensure that his investors would be able to realize their returns.[3] And for the five year period from 2012 through 2016, the net draw to Mr. Dersovitz averaged approximately *negative* $290,000 per year.

II. THE *PETERSON* CASES

Since forming the Funds in 2007, Respondents have consistently employed the same opportunistic strategy, deploying capital to capture strong returns for investors when unique and attractive opportunities present themselves. One such opportunity concerned providing financing to the attorneys and plaintiffs who had secured non-appealable judgments against the government of Iran related to the 1983 bombing of a United States Marines barracks in Beirut, Lebanon. Mr. Dersovitz always maintained the assets from these financings were the "best trade in the book." Time has shown him to be correct.

Evolution of the *Peterson*-Related Cases

On October 23, 1983, a terrorist group sponsored by the government of the Islamic Republic of Iran attacked a U.S. Marine barracks in Lebanon, killing and injuring a large number of American servicemen and women. Representatives of the victims filed multiple civil actions against Iran in the United States District Court for the District of Columbia, including *Peterson v. Islamic Republic of Iran*, 264 F. Supp. 2d 46 (D.D.C. 2003) (*Peterson I*). The plaintiffs established jurisdiction under the Foreign Sovereign Immunities Act ("FSIA"), which allows legal actions where "money damages are sought against a foreign state for personal injury or death that was caused by an act of . . . extrajudicial killing." 28 U.S.C. § 1605A(a)(1). In 2003, the District Court entered a default judgment against Iran, *Peterson I*, 264 F. Supp. 2d at 60-65,

3. *See* Ex. 2378, Net Draw to Roni Dersovitz from Combined Operating Companies (RDLC, RDLF, and RDLG).

and later awarded the *Peterson* plaintiffs approximately $2.65 billion in compensatory damages. *Peterson v. Islamic Republic of Iran*, 515 F. Supp. 2d 25, 60 (D.D.C. 2007).

In 2008, the United States government took an extraordinary step to support the claims of the *Peterson* plaintiffs. The Undersecretary of the United States Department of Treasury contacted Steven Perles, one of the lead private attorneys for the plaintiffs, and advised him that the United States had discovered that more than $2 billion in securities were being held illegally in an account at Citibank in New York as part of a conspiracy to hide assets owned by the Central Bank of Iran. With this information, the plaintiffs registered their judgments in the United States District Court for the Southern District of New York and obtained writs restraining the transfer of the funds at issue and seeking to enforce the judgments pursuant to the 2008 amendments to the FSIA. *See* 28 U.S.C. § 1610(g)(1) (allowing for judgment enforcement against assets of foreign terrorist state or its agencies or instrumentalities).

In June 2010, the plaintiffs initiated an action in the Southern District of New York,[4] additionally seeking turnover of the restrained assets under Section 201(a) of the Terrorism Risk Insurance Act ("TRIA"), which provides that "in every case in which a person has obtained a judgment against a terrorist party . . . the blocked assets of that terrorist party (including the blocked assets of that terrorist party) shall be subject to execution or attachment."[5] On February 5, 2012, President Barack Obama signed Executive Order 13,599, which blocked the assets at

4. Ex. 2486, Complaint, Peterson v. Islamic Republic of Iran, No. 10 Civ. 4518 (ECF 1) (filed under seal).

5. Terrorism Risk Insurance Act of 2002 ("TRIA"), Pub. L. No. 107-297, § 201(a), 116 Stat. 2322, 2337 (codified at 28 U.S.C. § 1610 Note "Satisfaction of Judgments from Blocked Assets of Terrorists, Terrorist Organizations, and State Sponsors of Terrorism"). The court consolidated the July 2008 and June 2010 actions.

issue in the litigation.[6] The *Peterson* plaintiffs then moved for partial summary judgment under TRIA.[7]

In August 2012, while the plaintiffs' motion for summary judgment was still pending, Congress took the extra step of including a provision in the Iran Threat Reduction and Syria Human Rights Act of 2012 that attempted to accelerate the payments due to the *Peterson* plaintiffs. That provision, codified at 22 U.S.C. § 8772, states that "the financial assets that are identified in and the subject of proceedings in . . . *Peterson et al. v. Islamic Republic of Iran* . . . shall be subject to execution . . . in order to satisfy any judgment to the extent of any compensatory damages awarded against Iran for damages for personal injury or death caused by an act of . . . extrajudicial killing . . . or the provision of material support or resources for such an act." Pub. L. 112-158, § 502, 126 Stat. 1214, 1258.

In February 2013, Judge Katherine Forrest granted summary judgment to the plaintiffs (eighteen groups of judgment creditors, comprised of more than a thousand individuals) under TRIA and § 8772, and ordered the turnover of the restrained assets at Citibank.[8] *See Peterson II*, No. 10 Civ. 4518, 2013 WL 1155576. The Second Circuit unanimously affirmed the district court's order, *Peterson v. Islamic Republic of Iran*, 758 F. 3d 185 (2d Cir. 2014),[9] and the Supreme Court entered judgment affirming the court of appeals in April 2016. *Bank Markazi v. Peterson*, 136 S.Ct. 1310, 1317 (2016).

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6. Exec. Order No. 13,599, 77 Fed. Reg. 6659, 6659 (Feb. 5, 2012).

7 *See* Plaintiffs' Notice of Motion for Partial Summary Judgment, Peterson v. Islamic Republic of Iran, No. 10 Civ. 4518 (ECF 209) (Apr. 2, 2012).

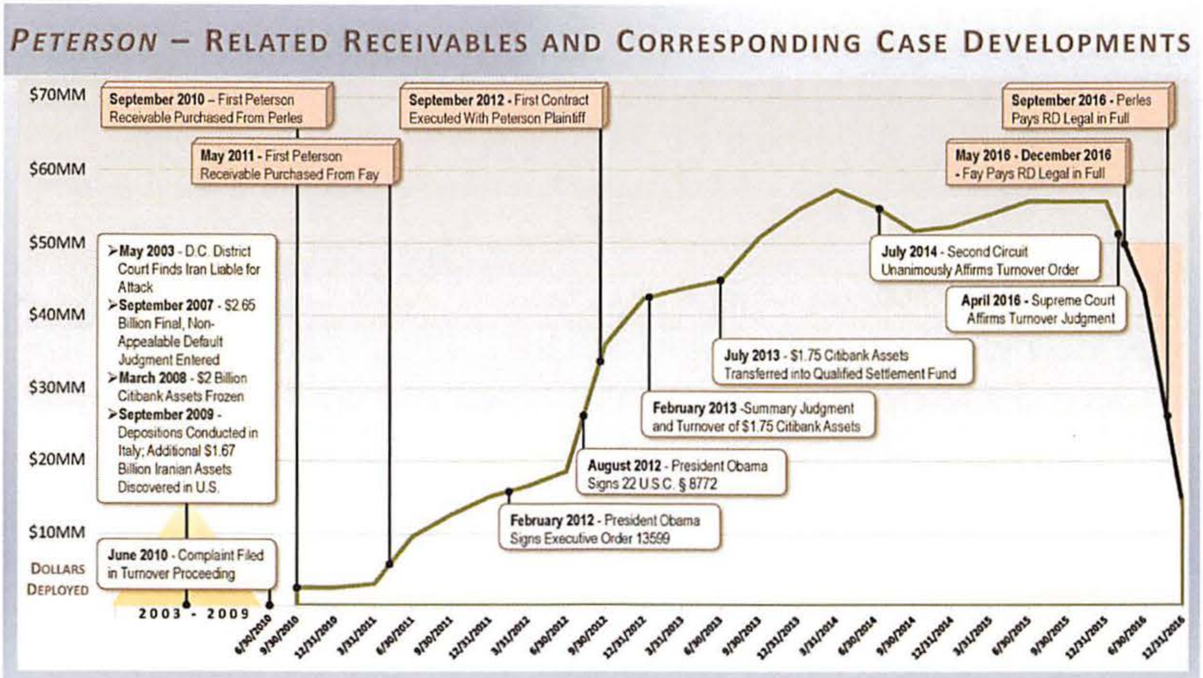
8. Ex. 1635, Order, Peterson v. Islamic Republic of Iran, No. 10 Civ. 4518 (ECF 337) (Feb. 28, 2013); Ex. 1636, Opinion and Order, Peterson v. Islamic Republic of Iran, No. 10 Civ. 4518 (ECF 367) (Mar. 13, 2013) (filed separately under temporary seal on Feb. 28, 2013).

9. The Second Circuit limited its holding to § 8772, finding that that provision alone was dispositive. *See* Ex. 2020, *Peterson v. Islamic Republic of Iran*, 758 F.3d 185, 188 (2d Cir. 2014).

Investment in *Peterson* Assets

Realizing the opportunity provided by the *Peterson* cases, where a corpus of money had been forfeited and was under the control of the United States government—and where all three branches of the federal government ultimately directed that those funds go to the plaintiffs—Mr. Dersovitz extended financing to both attorneys and plaintiffs in the litigation. Through his relationship with attorney Steven Perles, his understanding of complex legal proceedings, and his ability to draw upon the expertise of other professionals, Mr. Dersovitz enjoyed an information advantage that allowed him to capitalize on the opportunity the *Peterson* cases presented. The resulting investments he made have proven to be some of the most profitable in the history of the Funds.

A review of a timeline of the *Peterson* litigation shows that Mr. Dersovitz strategically increased the size of the Funds' *Peterson* investments as the likelihood of the plaintiffs' recovery became ever more certain. The graph below, which is also attached in full size at Tab A, shows that the dollars deployed in these investments grew as significant milestones leading to the collection of the assets were reached:



Notably, not a single dollar was deployed on *Peterson* until after depositions taken in Italy confirmed (through on-the-record admissions by Italian bank officials) that the frozen assets at Citibank were in fact being held for the beneficial ownership of the central bank of Iran. (*See* Tab A, Peterson-Related Receivables and Related Case Developments.) Thus, the first *Peterson* receivable was not purchased until 2010, three years after the entry of the non-appealable default judgment and seven years after the initial finding of liability against Iran for the terrorist attack. Similarly, as other significant steps towards collection were achieved—such as the issuance of the presidential blocking order and the passage of § 8772, both of which Mr. Dersovitz was aware of in advance—the Funds' positions in *Peterson*-related receivables were increased. (*See id.*)

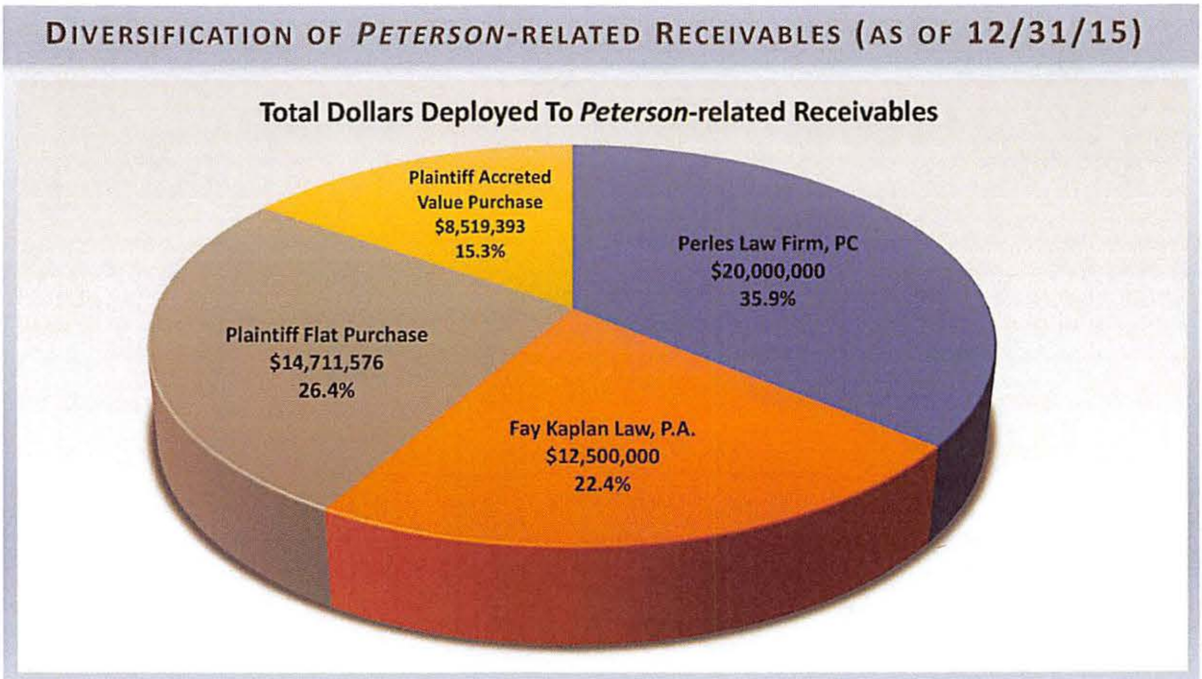
<u>Diversity of the *Peterson* Assets</u>

There was never one single "*Peterson*" position, and the Division's attempt to group the various *Peterson* receivables together as a single "concentration" ignores the diverse attributes of the underlying assets.

The *Peterson* assets can be divided into several distinct groups with different duration and credit risk profiles. First, the attorney receivables were originated from two law firms with long standing relationships with RD Legal. The agreements these firms signed contained broad guarantees and provided recourse for RD Legal against all assets of those firms for any monies owed related to *Peterson.* Thus, the collection of the funds owed from these firms was never dependent on the outcome of the *Peterson* case. There was always "boot collateral" backing these positions, regardless of the result of the *Peterson* proceedings. Second, the *Peterson* plaintiff receivables included both: (1) financings at a purchase price that accretes value at a rate of 18% per annum, and (2) flat-fee purchases of a portion of a plaintiff's judgment.

The differences between these trades significantly impacted the duration risk for the portfolio, because any time the expected payment date for the *Peterson* claims was extended (such as when the Supreme Court granted *certiorari*) the attorney receivables and the plaintiff financings became *more valuable* for the Funds (as the value of the investments would accrete over time), while the plaintiff flat-fee purchases became slightly less so. This dynamic insulated the portfolio from loss as duration was extended.

By way of example, the chart below, which is also attached at Tab B, shows the various classes of *Peterson* assets (Perles Law Firm, Fay Law Firm, Plaintiff Financing, and Plaintiff Purchases) as a percentage of the overall *Peterson* positions in terms of dollars deployed as of December 31, 2015:



Excess Collateral

In addition, all of the *Peterson* receivables in which the Funds invested were backed by multiple, independent collateral sources for payment, as well as multiple, independent legal bases upon which collection could be made. These included:

- $2 billion in proceeds from the Citibank account that were reachable under the FSIA, TRIA, or § 8772, and that were ultimately placed into a Qualified Settlement Trust for the benefit of the *Peterson* plaintiffs.
- The United States Attorney for the Southern District of New York filed an action in 2009 seeking the forfeiture of several tracts of real property, including 650 Fifth Avenue in New York, which had been purchased illegally for the benefit of the government of Iran.[10]

10. Stipulation and Order of Settlement Between the United States and Certain Third-Party Claimants 10, 1:08-cv-10934-KBF (S.D.N.Y. Apr. 16, 2014).

- Congress passed the Justice for United States Victims of State Sponsored Terrorism Act,[11] which provides a mechanism for victims of terror to receive restitution. The *Peterson* plaintiffs would have been eligible to seek payment under this statute if for any reason they were not able to collect against the funds held in the Qualified Settlement Trust.

- President Obama entered a blocking order in February 2012 under the sanctions framework created by Congress, freezing all property and interests held for the government of Iran or any Iranian financial institution.[12] Whatever the outcome of the *Peterson* litigation, the proceeds from the securities that had been held at Citibank were never going to be returned to Iran. Those funds ultimately would have been made available to the victims of terror.

- The *Peterson* assets held in the Funds arising from the plaintiff law firms were secured against the full assets of those firms on a going forward basis.

All of these independent, overlapping sources of payment on the *Peterson* judgments removed any meaningful credit risk as to repayment on the assets held in the Funds. The decision of the fund manager to invest heavily in this opportunity has proved to be correct and extremely profitable for investors.

PROCEDURAL BACKGROUND

The Commission initiated this administrative proceeding against Respondents by filing an Order Instituting Administrative and Cease-and-Desist Proceedings ("OIP") on July 14, 2016. The OIP asserts that Respondents violated the federal securities laws by "(i) marketing and selling investments in two funds based on misrepresentations concerning the type and diversification of assets under management in these funds, and (ii) by withdrawing money from the funds using valuations based on unreasonable assumptions . . . ." OIP ¶ 1. The vast majority of the OIP focuses on the Funds' financing of *Peterson*-related receivables discussed above.

11. 42 U.S.C. § 10609 (2016).

12. Exec. Order No. 13,599, 77 Fed. Reg. 6659, 6659 (Feb. 5, 2012).

As will be shown at the hearing: (1) Respondents did not make misrepresentations regarding the Funds' investments or assets under management, and Mr. Dersovitz repeatedly called the *Peterson*-related investments "the best trade in the book"; and (2) the values associated with the *Peterson*-related investments have proven to be accurate, and the Funds and their investors have received their expected return based on those valuations.

DISCUSSION

The Division brings its claims against Roni Dersovitz and RD Legal under Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, each of which prohibits categories of fraudulent conduct in the offer or sale of securities or in connection with the purchase or sale of securities. *See* OIP ¶ 75. The Division's allegations can be divided into claims regarding alleged misstatements (discussed *infra*, Section I), and claims regarding an alleged scheme to unreasonably value the Funds' assets (discussed *infra*, Section II).

As shown below, the Division lacks any credible evidence showing that Respondents engaged in any improper conduct, or in any way strayed from what the Funds' governing documents expressly permitted them to do. Respondents respectfully ask this Court to hold the Division to its burden, and reject its attempts to manufacture liability where clearly none exists.

I. THE DIVISION'S MISSTATEMENT CLAIMS HAVE NO MERIT

There is no evidence to support the charge that Respondents made any material misstatements or omissions regarding the type of investments in the Funds or the concentration levels of those investments. To the contrary, while Respondents always maintained flexibility and exercised discretion when unique opportunities such as *Peterson* came along, they always pursued the same basic strategy set forth in the offering documents. Moreover, investors and prospective investors could look to numerous sources to observe the Funds' overall concentration and exposure to particular positions—including the Funds' audited financial statements, independent valuation reports, and even a database containing all of the underlying documents for the underwriting of each position in the Funds' portfolio.

A. The Division Cannot Demonstrate that Respondents Made Any Material Misstatements or Materially Misleading Omissions Concerning the Type of Investments in the Funds

The Division's case is based in large part on its belief that the Funds' investments in receivables related to the final, non-appealable *Peterson* judgment were somehow materially distinct from the Funds' investments in receivables related to cases that had settled and awaited further legal process, and that the Funds' investors would have recognized or been influenced by this distinction. This entire theory hangs on a false premise.

1. The Funds Adhered to Their Investment Strategy

Respondents consistently adhered to one overall investment strategy, which was accurately communicated to investors: the Funds discount the future cash flows their clients will collect at the end of a legal proceeding. Regardless of whether the client expects a future cash flow from a settlement or a judgment, RD Legal asks the same questions to assess the credit risk associated with a particular receivable: Is the obligor credit-worthy? Has the a corpus of money been identified from which to collect? Is the money in a bankruptcy remote vehicle? Has the client signed a security agreement?

The credit risk associated with a particular receivable is not tied to whether it is derived from a "settlement" or "judgment," but rather with the risk of non-payment due to insolvency or other default of the settlement or judgment obligor. In either case the strategy is to provide financing to bridge the time between someone obtaining an entitlement to money and ultimately collecting it. There is always an intervening legal process, and time horizon, that needs to be bridged—otherwise no counterparty would ever seek financing.

Providing this bridge-financing for legal receivables—whether deriving from "a claim that has been reduced to judgment" or, more typically in the history of the Funds, a settlement requiring judicial approval—was one single, coherent investment strategy.[13] The Division's attorneys (who of course are not experts in this field themselves) simply fail to grasp the essential economic principles that underlie the Funds' incontrovertible success. Indeed, the distinction between "settled actions" requiring court approval, on the one hand, and "non-appealable judgments" where a corpus of money has been identified for collection, on the other, is not meaningful from an economic standpoint. Both require an ongoing legal proceeding and judicial approval.

As testimony at the hearing will demonstrate, investors in the Funds did not concern themselves with the myriad technical differences between the underlying legal cases in which the Funds invested; rather, they focused on the economic substance of their investments.

2. Investors Were Told the Funds Would Invest in Settlements *and* Judgments—Including the *Peterson* Litigation

Reasonable investors in the Funds understood that the Funds invested in legal receivables associated with settlements requiring judicial approval and judgments where a corpus of money has been identified, including the *Peterson* litigation. Respondents clearly stated in offering documents, due diligence information, marketing materials, and oral and written communications that the Funds invested in both settlements and judgments.

13. Respondents also at times offered lines of credit and other advances to participants in the legal process, which did not otherwise fall within the Funds' primary factoring strategy. This, too, was consistently conveyed to investors and prospective investors at all relevant times.

In any private fund, the offering memorandum is the cornerstone of the "total mix" of information "made available" to investors.[14] Understanding this principle and following industry norm, Respondents *required* all investors in the Funds to attest that they had reviewed the offering memorandum prior to investing.[15] Significantly, every version of the offering memorandum for the Funds since their inception in July 2007 has identified legal judgments as being one of the "Legal Fee Receivables" purchased by the Funds.[16]

For example, the very first page of the June 2013 Offering Memorandum for the Domestic Fund stated under "Investment Objective and Strategy":

> The Partnership will (i) purchase from law firms and attorneys (collectively, the 'Law firms') certain of their accounts receivable representing legal fees derived by the Law Firms from litigation, ***judgments*** and settlements ('Legal Fee Receivables'), (ii) purchase from certain plaintiffs accounts receivable representing the plaintiff's

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14. *See, e.g.*, *Brown v. E. F. Hutton Group, Inc.*, 991 F.2d 1020, 1032 (2d Cir. 1993) ("[W]ith respect to the Partnership's risks, the Brochure directs the potential investor to the Prospectus, the single most important document and perhaps the primary resource an investor should consult in seeking that information."); *Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2, 9 (2d Cir. 1996) ("Representations made by the defendants at the roadshows are immaterial since they are contradicted by plain and prominently displayed language in the prospectuses."); *Dodds v. Cigna Secs., Inc.*, 12 F.3d 346, 351 (2d Cir. 1993) ("Nor can a plaintiff rely on misleading oral statements to establish [a Section 10(b)] unsuitability claim when the offering materials contradict the oral assurances."); *Carr v. CIGNA Securities, Inc.*, 95 F.3d 544, 547 (7th Cir.1996).

15. *See* Ex. 2085, RD Legal Funding Partners, LP Subscription Documents, ¶ 8. Specifically, all investors in the Funds were required to attest as follows:

    In deciding to invest in the Partnership, Subscriber has relied solely upon the information in the Memorandum and nothing else. Subscriber acknowledges that no person is authorized to give any information or to make any statement not contained in the Memorandum, and that any information or statement not contained in the Memorandum must not be relied upon as having been authorized by the Partnership.

    Id. at Ex. 2085_0004.

16. *See, e.g.*, Ex. 2396, Amended Expert Report of Leon Metzger dated February 13, 2017 ("Metzger Report") ¶ 70 (tracking the inclusion of the term "judgments" in the "Investment Objective and Strategy" section of every version of the PPM for the Domestic Fund from July 2007 to June 2013).

> portion of proceeds arising from ***final judgment awards*** or settlements . . . .[17]

The various offering memoranda explicitly reiterated in several subsequent sections that the Funds could invest in both settlements and judgments.[18]

Moreover, the Funds' offering memoranda made clear to investors and prospective investors that Respondents retained ultimate discretion and flexibility with respect to the Funds' operation. For example, the Domestic Fund's 2013 Offering Memorandum consistently stated that the Partnership "will not be limited with respect to the types of investment strategies it may employ or the markets or instruments in which it may invest."[19] It further advised investors that "[o]ver time markets change, and the General Partner will seek to capitalize on attractive opportunities, wherever they might be," and that "the General Partner may pursue other objectives or employ other techniques it considers appropriate and in the best interest of the Partnership."[20]

That the Funds invested in legal receivables arising out of judgments was also readily apparent to anyone who reviewed the extensive due diligence materials Respondents made available to prospective investors. Respondents for years maintained an investor website where current and prospective investors who signed a non-disclosure agreement could view detailed information about the Funds' portfolio compositions, audited financial statements, and other information, including an independent accountant's Report on Agreed Upon Procedures

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17. *See* Ex. 1719, June 2013 Offering Memorandum for Domestic Fund, p. 1 (emphasis added); Ex. 1715, June 2013 Offering Memorandum for Offshore Fund, p. 1.

18. *See* Ex. 1719, June 2013 Offering Memorandum for Domestic Fund, p. 7 (under the heading "Investment Program"); Ex. 1715, June 2013 Offering Memorandum for Offshore Fund, p. 7 (same); *see also* Ex. 1719 at pp. 9, 14 and Ex. 1715 at pp. 9, 17 (discussing recourse in the event of nonpayment and "Counterparty and Credit Risk").

19. *See* Ex. 1719, June 2013 Offering Memorandum for Domestic Fund, p. 13.

20. *See id.*

("AUP"), explaining certain workout positions in the portfolio. Respondents also maintained a Lotus Notes database, separate from the website, which they made available to investors and which contained the underlying documentation for every position in the Funds.

Mr. Dersovitz and others at RD Legal were also very open in their marketing presentations and emphasized that the Funds invested in legal fee receivables arising out of judgments as well as settlements. Indeed, the "Frequently Asked Questions" ("FAQs") document and the "Due Diligence Questionnaire" ("DDQ") that were provided to prospective investors explicitly mentioned that the Funds invested in judgments, as well as settled cases. Moreover, as Mr. Dersovitz has testified—and will again testify at trial—he never missed an opportunity to talk about the *Peterson* case with investors and prospective investors in the Funds, as he considered those positions to be the "best trade in the book."

3. Isolated Statements in the Funds' Marketing Documents and Other Communications Cherry-Picked by the Division Were Immaterial

To overcome the obvious disclosures in the offering documents and other materials made available to investors, the Division cherry-picks statements in the Funds' marketing materials and other one-off communications with investors or prospective investors to suggest that Respondents were somehow misleading investors about their investment strategy. For an alleged misrepresentation or misleading omission to qualify as "material," there must be a "substantial likelihood that the disclosure of [an] omitted fact would have been viewed by a reasonable investor as having significantly altered the total mix of information made available."[21] An analysis of materiality "does not focus on whether particular statements, taken separately, were

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21. *Harding Advisory LLC*, Opinion of Commission, SEC Release No. 4600, 2017 WL 66592 at *6 (Jan. 6, 2017) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

literally true, but whether defendants' representations, taken together and in context, would have misled a reasonable investor about the nature of the securities."[22]

As Leon Metzger, one of Respondents' experts, explained in his report, "marketing documents are one piece of a mosaic that must be considered in the context of all of the information made available to investors by the fund's investment manager."[23] Thus, while the Division will focus on the fact that Respondents used examples of financing "settled" cases to explain their investment strategy to investors, those statements were not made in isolation and would not have been independently relied upon by any reasonable investor.[24] Rather, they were one piece in the broader "total mix" of information made available to investors.

The evidence at the hearing will show that reasonable investors understood that private fund marketing materials are not intended to contain a full and complete statement of all of the Funds' current and future investments,[25] and that the Funds repeatedly disclosed in their offering documents and other investor materials that Respondents would invest in "litigation, *judgments* and settlements."[26]

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22. *DeMaria v. Andersen*, 318 F.3d 170, 180 (2d Cir. 2003) (discussing statements made in prospectuses) (internal quotation marks and citation omitted).

23. Ex. 2396, Metzger Report ¶¶ 13(i), 35-58, 138.

24. *Cf. Haberland v. Bulkey*, 896 F. Supp. 2d 410, 424 (E.D.N.C. 2012) ("An omitted fact is not material when the facts underlying it are fully disclosed and publicly available.").

25. *See Flannery v. SEC*, 810 F.3d 1, 11 (1st Cir. 2015) (discussing expert analysis showing that "[p]re-prepared documents such as ...presentations ... are not intended to present a complete picture of the fund, but rather serve as starting points, after which due diligence is performed."); Ex. 2396, Metzger Report ¶¶ 13, 35 ("Reasonable accredited investors should have understood that the funds' marketing materials were meant to provide a brief summary of the investment opportunity only and did not purport to contain all relevant terms that may be of interest to prospective investors," and that hedge fund marketing materials are snapshots to whet the investors' appetites).

26. *See* Ex. 2396, Metzger Report ¶70 (expert survey of every version of the Domestic Fund's offering documents disclosing Fund's investments in "judgments").

4. The Other Receivables Identified in the OIP Were Classic Workout Situations that Were Consistent with the Funds' Strategy and Fully Disclosed to Investors

In the OIP, the Division raises allegations that Respondents provided financing to a firm identified as "Law Firm A" on positions that did not derive from either legal settlements or judgments. These positions arose out of funding that was originally provided to a successful personal injury firm, Beatie and Osborn LLP ("Beatie and Osborn"), and are the result of a financial workout when that firm dissolved.

Respondents had enjoyed a successful relationship with Beatie and Osborn over several years and had funded and collected more than $7 million in capital from that firm. In 2009, Beatie and Osborn broke apart and was succeeded by Osborn Law, P.C. ("Osborn"). At the time of dissolution, Beatie and Osborn owed money to the Funds from previous capital advances, and the collection of those advances was jeopardized. Respondents therefore commissioned a third-party firm to conduct due diligence to examine the case inventory of the new Osborn firm and to determine the legal fees likely to be generated from that inventory.

Based on this analysis, Respondents decided to continue to fund Osborn to keep the new firm solvent to pursue collections on its case inventory. In particular, Osborn had a number of consolidated product liability cases against Novartis Pharmaceutical Corporation related to a defective prescription product. Respondents believed the future legal fees to Osborn on these cases would be more than sufficient to cover all past capital advances, including accreted income on those positions. Respondents therefore made the decision to continue to fund Osborn during the time it pursued these cases. The alternative—letting the Osborn firm simply collapse—would have led to an immediate loss to the funds.

Notably, the full history of the Osborn positions was disclosed to investors in quarterly reports by the independent accountants since at least 2010.[27] This was also contained on the investor website, and the concentration of the Novartis cases was disclosed to investors in the audited financial statements. All of these facts were shown in plain sight.

B. Peterson Concentration Levels in the Funds Were Disclosed to Investors, Decreased the Overall Portfolio Risk, and Were Immaterial to a Reasonable Investor's Investment Decisions

The Division also contends that Respondents misled investors about the concentration of investments in the Funds, specifically in relation to the *Peterson* litigation.[28] As noted above, Mr. Dersovitz had discretion under the Funds' offering memoranda to concentrate assets in the portfolio as he saw fit in order to maximize returns and reduce the overall portfolio risk. This approach was made clear to investors from the Funds' inception. A reasonable investor would have understood that the Funds could be—and were—heavily invested in *Peterson* receivables.

Moreover, reasonable investors do not consider information about diversification valuable as an end unto itself: rather, investors consider such information valuable to the extent that diversification has bearing on economic aspects of the investment—*i.e.*, the impact on risk. The evidence at trial will show that *Peterson* trades not only *diversified* the risk profile of the Funds, but also have proven to be among the best performing in the Funds.

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27. The OIP also makes reference to investments in receivables referred to as "Law Firm B." These positions concern the Cohen law firm and related to financing a settlement of a *qui tam* action and related proceedings. Not only did these trades originate from a settlement, they—like the Osborn positions discussed above—were fully disclosed to investors in the AUPs and audited financial statements. There was also a second criminal legal fee due to the law firm, and the underlying law firm client pledged both a mortgage and Title Policy, which was similarly disclosed to investors.

28. *See e.g.*, OIP ¶ 20.

1. The Offering Memoranda and Other Fund Materials Disclosed that the Funds Could Be Concentrated and Not Broadly Diversified

The offering documents clearly disclosed that the Funds pursued an opportunistic strategy and would be concentrated, and specifically afforded RD Legal the flexibility to invest disproportionately in attractive opportunities.[29] In pertinent part, the offering memoranda expressly informed investors that (1) the Funds would be concentrated in particular types of assets, and would never offer a "broadly diversified portfolio" and (2) that concentration in one type of investment can carry with it increased risk.[30] The offering documents also warned that

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29. For example, the Confidential Private Offering Memorandum for investors in the Domestic Fund stated as follows:

> Investment Concentration
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> The Partnership intends to invest the assets of the Partnership in either Receivables, Lines of Credit or Other Advances to Law Firms. By investing solely in these instruments, the assets of the Partnership will be exposed entirely to the risks of such investment ***without the protections against loss afforded by diversification***. Concentration in a certain type of investment has the effect of exposing a significant portion of invested capital to the same or similar risks, as well as return or other characteristics, and ***thereby increases investment risk as well as the portfolio volatility***. Accordingly, the value of a Partnership investment may fluctuate more widely given this concentration, as ***compared with the fluctuation expected in a broadly diversified portfolio***."
>
> ***
>
> Flexibility
>
> The Partnership will not be limited with respect to the types of investment strategies it may employ or the markets or instruments in which it may invest. Over time markets change, and the ***General Partner will seek to capitalize on attractive opportunities, wherever they might be***. Depending on conditions and trends in securities markets and the economy generally, the General Partner may pursue other objectives or employ other techniques it considers appropriate and in the best interest of the Partnership.

See, e.g., Ex. 1719, June 2013 Offering Memorandum for Domestic Fund, pp. 13, 15 (emphasis added); Exhibit 1715, June 2013 Offering Memorandum for Offshore Fund, pp. 15, 19. Earlier versions of the offering memoranda contained similar language. *See, e.g.*, Ex. 2396, Metzger Report ¶ 70 (tracking these clauses for every version of the Domestic Fund from July 2007 to June 2013).

30. *Id.*

the value of an investment in the Funds "may fluctuate more widely given this concentration, as compared with the fluctuation expected in a broadly diversified portfolio."[31]

Respondents thus had full discretion to move nimbly and to invest in assets in one or a few positions that they considered to be exceptional—such as those related to the *Peterson* litigation—to deliver investors outsized returns. In fact, taking on a heavily concentrated position is a common tactic used by alternative investment managers to obtain the absolute returns sought by investors.[32] In this case, the exercise of this "flexibility" has worked as designed for the benefit of investors, helping ensure strong double-digit returns for the Funds.[33]

2. Actual Concentration Levels Were Known and Knowable to Investors

Reasonable investors in the Funds would know the Funds had invested in the *Peterson* judgments, as the existence and concentration of *Peterson* assets in the Funds were disclosed to investors in the audited financial statements (among other sources), were made available to the investors on the Funds' investor website, and were specifically disclosed in investor communications.

Going back to 2010, the Funds' audited financial statements listed the *Peterson* assets collectively and disclosed that the Funds were heavily concentrated with respect to its top obligor

31. *Id.*

32. Taking on a heavily concentrated position is a commonly employed investment strategy that alternative investment funds, unlike other securities issuers, are able to employ despite the associated risks. *See* SEC Memorandum, Division of Investment Management, *Comment on Proposed Rule, Registration Under the Advisers Act of Certain Hedge Fund Advisers* (Release No. IA-2266; File No. S7-30-04), 2004 WL 3385692, at *2 (Aug. 20, 2004).

33. Ex. 2396, Metzger Report ¶¶ 26, 59-62 and Appendix C.

positions.[34] This information was made readily available by Respondents, and should have been obvious to any investor upon the completion of basic due diligence.

In addition, the concentration in *Peterson*-related assets was specifically disclosed to investors, both collectively and individually, on many occasions. For example, in February 2012, RD Legal wrote to its investors about the *Peterson* investment and explained that the Funds had $15 million invested, would increase the concentration to 30%, and may be "increasing our exposure" in the future.[35] By August 2012, RD Legal explained to investors that the Funds had deployed $25 million to the *Peterson* attorneys. In short, Mr. Dersovitz's zeal for the *Peterson* trades was never hidden, and these positions were always communicated to investors.[36]

3. The Funds' Concentration Levels Decreased the Overall Portfolio Risk and Are Immaterial to the Investment Decisions of a Reasonable Investor

Reasonable investors care about concentration only insofar as it increases the risk of an investment. As the First Circuit noted in *Flannery*—a case that also involved purported misstatements concerning investment concentration—it is not "diversification as such" that establishes materiality.[37] Rather, it is increased exposure to risk resulting from concentration

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34. Ex. 2396, Metzger Report ¶ 94.

35. Ex. 1324, Letter to investors dated Feb. 28, 2012.

36. The Funds' 2012 audited financial statements accurately identified the "Payor" for the *Peterson* judgments as "Funds under control of the US Government" because, on February 5, 2012, President Obama signed an Executive Order blocking the assets from which the *Peterson* judgments could be paid from leaving the United States. Similarly, the Funds' later financial statements accurately identified the "Payor" for the *Peterson* judgments as a "Qualified Settlement Trust" because, in March 2013, the United States District Court for the Southern District of New York entered an order turning the assets in question over to the *Peterson* plaintiffs and placing those assets in a *Qualified Settlement Trust* under the direction of the Honorable Stanley Sporkin as trustee.

37. *Flannery*, 810 F.3d 1, 10-14.

that is important to investors.[38] Here, both of Respondents' experts explained that the concentration in *Peterson*-related receivables was *good* for the portfolio and *beneficial* to investors. In contrast, the record in this case is devoid of any evidence that concentration in the *Peterson* receivables actually resulted in increased risk exposure.[39]

a) The *Peterson* Assets Were Comprised of Distinct Investments with Different Risk Profiles

The Division argues that, by misstating or omitting information about the Funds' concentration in the *Peterson* receivables, Respondents portrayed the Funds as more diversified—and thus as lower risk—than they truly were. The false premise of that argument is that the *Peterson* receivables represented a single undifferentiated investment sharing identical risks. In fact, as noted in David Martin's expert report, the *Peterson* receivables differed by type (attorney-fee receivables vs. plaintiff receivables), payoff structure (receivables with per diem rebate provisions versus receivables with no such provisions), and expected returns and durations.[40] As a result, the *Peterson* receivables had "different, non-correlated risk profiles."[41] They were thus never "one" position, with one profile, within the portfolio.[42]

38. *See In Re Fundamental Portfolio Advisors, Inc.*, Release No. 2146, 2003 WL 21658248, at *12 (July 15, 2003); *In the Matter of Mohammed Riad & Kevin Timothy Swanson*, Release No. 4420A (July 7, 2016) (citing cases).

39. *See Hutchinson v. CBRE Realty Finance, Inc.*, 638 F.Supp. 2d 265, 277 (D. Conn. 2009) (failure to disclose debtor's distress not material where company not at risk).

40. Exhibit 2393, Martin Report ¶¶ 14, 40-49.

41. *Id.*

42. In bringing this case, the Division chose to ignore that the concentration complained of was comprised of 60% legal receivables from law firms secured by law firm and personal assets. The other positions were spread among various plaintiffs and had multiple settlement funds from which the judgments could be satisfied.

b) The Multiple Sources of Collateral to Satisfy the *Peterson* Judgments Created a Low Credit Risk

Significantly, the credit risk of the *Peterson* receivables—i.e., the risk of obligor non-payment—was lower than the credit risk of the typical RD Legal trade because of the multiple sources of collateral available to satisfy the underlying obligations. Specifically, the obligations to RD Legal could have been satisfied if the judgments were collected through any variety of sources: (1) the $2 billion of frozen assets at Citibank that were reachable through § 8772 or TRIA, or even simply as a violation of the FSIA; (2) funds from the forfeiture of the property at 650 Fifth Avenue; (3) $1 billion from the United States Victims of State Sponsored Terrorism Act, 42 U.S.C. § 10609; or (4) any other assets of Iran that were located to satisfy the judgments.

Moreover, RD Legal's purchases of attorney fee receivables from the Fay Firm and the Perles Firm were secured by all of the receivables of those firms (not just the *Peterson* case receivables) and guarantees from the law firms. Investors' return on those assets was never contingent on the outcome of the *Peterson* turnover action, and both firms paid off their obligations to the Funds prior to the distribution of the frozen assets by the trustee.

c) The Risks Associated with the *Peterson* Assets Diminished over Time

The Division incorrectly assumes that the risks associated with the *Peterson*-related assets were correlated to the concentration of those assets in the portfolio, as opposed to the developments in the *Peterson* turnover action. Mr. Dersovitz worked closely with the attorneys in the *Peterson* cases, and outside counsel monitoring the *Peterson* turnover action, and increased the Funds' investments at a rate that corresponded with the developments in the case and that decreased the overall risk of the portfolio.[43] In other words, Mr. Dersovitz had an information edge, and he took advantage of it.[44]

For example, while Mr. Dersovitz had learned early on that Iran had laundered money through Citibank and that those assets could be available to satisfy the *Peterson* judgments, he did not direct that the Funds make an investment in *Peterson* receivables until after the Iranian government's ownership of those assets was legally established (following the Italian depositions). The initial advances to the Perles Law Firm and Fay Kaplan Law were conservative and were the functional equivalent of lines of credit that had always been part of the portfolio. Respondents began to purchase *Peterson* plaintiff receivables only after August 2012, when Iranian assets in the United States were frozen by action of the President of the United States and Congress passed § 8772 mandating that the frozen funds be available to satisfy the *Peterson* judgments. From there, the risks only decreased, and the concentration correspondingly increased. Leon Metzger explained in his expert report that "creating a large concentration in the *Peterson* assets after July 2013—i.e, *after* the final judgment in the *Peterson* turnover litigation—was akin to buying nearly risk-free U.S. Treasury securities . . . [and] reduced the overall portfolio risk."[45]

d) The Division's "Evidence" of Risk from the Concentration Is Pure Speculation

In contrast to the expert and empirical evidence that the concentration in *Peterson*-related assets *decreased* portfolio risk and was profitable, the Division has no evidence that the Funds'

43. Ex. 2396, Metzger Report ¶ 112.

44. Ex. 2393, Martin Report ¶ 51-57.

45. Ex. 2936, Metzger Report ¶ 112.

increasing purchases of the *Peterson* positions were anything but a very safe investment.[46] The Divisions' "allegations reflect a fundamental misunderstanding of diversification in the context of investing."[47] The issue of concentration is not binary—it is neither bad nor good solely based on the percentage of an asset in a portfolio. A concentrated investment in cash, for example, carries virtually zero credit risk.

The *Flannery* case is highly instructive. The Division in *Flannery* argued that the respondents had misrepresented the concentration of asset backed securities (ABS) as 55% of the portfolio, when in fact the actual investment in ABS reached 80% to nearly 100%.[48] The First Circuit, reversing the Commission, explained that "the Commission has not identified any evidence in the record that the credit risk posed by [the relevant types of investments] were materially different from each other, arguing instead that the percent of investment in ABS and diversification as such are important to investors."[49] In rejecting the Divisions' binary view of concentration, the First Circuit explained that the actual portfolio percentages were available to investors,[50] and concluded that individual misstatements about the concentration in the portfolio did not significantly alter the "total mix" of information made available.[51]

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46. The only evidence the Division presents to establish that investments in the *Peterson* receivables increased exposure to risk is its expert report, which compares the *Peterson* investment to the *Jacobson v. Oliver* case, where a court deemed that there was a "high" risk that an attorney would receive no proceeds from pursuit of a default judgment against Iran. (Sebok Report at 38-41.) But Professor Sebok makes no attempt to analyze the legal developments that occurred subsequent to the *Jacobson* case, to independently examine the actual risk associated with the *Peterson* receivables, or to differentiate between the risk to the *Peterson* attorneys and the risk to RDLC.

47. Ex. 2936, Metzger Report ¶ 114.

48. *Flannery*, 810 F.3d at 5.

49. *Id.* at 10-11.

50. *Id.* at 11.

51. *Id.* (quoting *Basic v. Levinson*, 485 U.S. 224, 232 (1998)).

Here, as in *Flannery*, an isolated statement in a marketing presentation or an email regarding concentration is not actionable in light of the total mix of information available to investors. Indeed, the concentration of the *Peterson* positions was always known and knowable to investors.[52] And these positions presented virtually no repayment risk.

At most, the Funds' investors faced a duration risk as a result of the *Peterson* investment. As explained above, however, investors were fully warned of the Funds' duration risk. In short, any purported misrepresentation or omission regarding "concentration" of investment in *Peterson* positions would not have been regarded as material by a reasonable investor, because any such concentration did not convey information about an increase in non-collection risk or concentration in a single risk position, and reasonable investors would not view the minimal duration risk presented by the *Peterson* positions as material to their investment decisions.

C. Respondents Did Not Act with an Intent to Deceive or with Extreme Recklessness in Representing the Funds' Investment Strategy or Concentration Levels

To successfully bring a claim under Section 17(a)(1), Section 10(b), or Rule 10b-5, the Division must prove that Respondents acted with scienter: that is, either with "an intention to deceive, manipulate, or defraud" or with "a high degree of recklessness." *Flannery*, 810 F.3d at 9 (internal quotation marks and citations omitted). Recklessness must be severe enough to amount to "an extreme departure from the standards of ordinary care so obvious that the actor

52. Even if concentration in *Peterson* positions could be considered "significant information" despite the diversification of those investments, any fleeting misstatements concerning the level of concentration in *Peterson* would have been immaterial. A reasonable investor would understand (and the offering documents disclose) that concentration levels are not fixed. New investments in a flagship fund would impact concentration; selling positions in the flagship fund would impact concentration; and legacy assets paying off would impact concentration. A reasonable investor would give little weight in the "total mix of information" to a single off-the-cuff statement regarding concentration levels at a one single point in time, understanding that concentration levels are not static and could increase (or decrease) at any time. Rather, a reasonable investor would refer to audited financial statements and the underlying data available to him to understand concentration on an ongoing basis.

must have been aware of it." *Howard v. SEC*, 376 F.3d 1136, 1148 (D.C. Cir. 2004). The discovery in this case has not produced any document or testimony to suggest that Mr. Dersovitz or anyone else at RD Legal made any statement either with the knowledge that the statement was false or with conscious disregard for the statement's truth or falsity.

Moreover, because "[q]uestions of materiality and scienter are connected," the Division faces an uphill battle in proving scienter where evidence of materiality is weak, as it is in this case. *Flannery*, 810 F.3d at 9. "If it is questionable whether a fact is material or its materiality is marginal, that tends to undercut the argument that defendants acted with the requisite intent or extreme recklessness in not disclosing the fact." *City of Dearborn Heights 345 Police & Fire Ret. Sys. v. Waters Corp.*, 632 F.3d 751, 757 (1st Cir. 2011).

The First Circuit's *Flannery* decision is once again illuminating. There, the First Circuit held that the evidence supporting materiality was "marginal" where an investor presentation stated that the private fund consisted of only 55 percent asset-backed securities, while in fact the true level of investment was between 80 percent and 100 percent. *Flannery*, 810 F.3d at 5, 10. The *Flannery* court also credited the unrebutted testimony of the respondents' expert that a reasonable investor would view the presentation as merely a "starting point[]" for information about the fund, noting that clients were "given specific information upon request" and that "information about the [fund's] actual percent of sector investment was available through the fact sheets and annual audited financial statements." *Id.* at 10-11 (internal quotation marks and citation omitted). In light of this "thin materiality showing," the *Flannery* court had no trouble concluding that the Division's evidence in that case could not "support a finding of scienter." *Id.* at 11; *see also, e.g., Fire and Police Pension Ass'n of Col. v. Abiomed, Inc.*, 778 F.3d 228, 243

(1st Cir. 2016) ("The marginal materiality of the alleged statements and omissions concerning revenues weighs against an argument that defendants . . . possessed the requisite scienter.").

If the evidence of materiality was thin in *Flannery*, it is surely translucent here. As explained above, there are numerous reasons why the alleged misrepresentations and omissions in this case were not materially misleading. Respondents' candidness in disclosing information regarding the nature of Fund assets and the riskiness of investing in the Funds undercuts the Division's unsupported argument for scienter. Respondents were uncommonly transparent not only regarding the concentration of Fund assets and the nature of the Funds' investment strategy, but also regarding the illiquidity of the Funds and the overall risk exposure of a nondiversified portfolio. "When adequate disclosures are made, it cannot be said that a defendant's conduct is highly unreasonable and represents an extreme departure from the standards of ordinary care." *In re Merrill Lynch Auction Rate Sec. Litig.*, 851 F. Supp. 2d 512, 529 (S.D.N.Y. 2012) (internal quotation marks and citation omitted); *see also In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1425 (9th Cir. 1994) ("The detailed risk disclosure in the Debenture Prospectus negates an inference of scienter.").

The Division cannot establish scienter for the further reason that it is undisputed that Respondents vetted all allegedly misleading marketing materials, offering documents, and other disclosures with experienced industry professionals. While reliance on the advice of professionals can be an affirmative defense, it can also be used as "simply evidence of good faith, a relevant consideration in evaluating a defendant's scienter." *Howard*, 376 F.3d at 1147 (internal citation omitted); *see also, e.g., SEC v. Shanahan*, 646 F.3d 536, 544 (8th Cir. 2011) ("Depending on others to ensure the accuracy of disclosures . . . is not severely reckless conduct that is the functional equivalent of an intentional securities fraud."); *Steed Fin. v. Nomura Secs.*

Int'l, 148 Fed. App'x 66, 69 (2d Cir. 2005) (affirming summary judgment on § 10(b) claim where defendant provided evidence of reliance on counsel in determining how to represent nature of securities). Such is the case here.

II. THE DIVISION CANNOT PROVE ITS VALUATION CLAIMS

In addition to the deficient misstatement claims described above, the Division separately alleges that Respondents "employed a scheme" to withdraw millions of dollars from the Funds by overstating the value of the portfolio based on "unreasonable assumptions." OIP ¶¶ 1, 60. The Division's conclusory allegations are undermined, however, by the abundant evidence that Respondents' valuation procedures fully met all applicable accounting guidelines and industry standards; and are further undermined by the fact that the valuations have proven to have been accurate.

A. Respondents Employed a Reasonable and Appropriate Valuation Process

The evidence at trial, including the unrebutted testimony of Respondents' experts, will show that Respondents went to extraordinary lengths to ensure that the Funds' valuation methodology complied with applicable accounting principles and industry practice and that the inputs used in Respondents' valuation process were based on an objective assessment of the risk characteristics of the underlying receivables. For its part, the Division has not designated a valuation expert or identified any evidence even suggesting that the ongoing valuation of Fund assets was anything short of Respondents' genuinely held assessment. There can be no basis for fraud under such facts.

1. The Illiquidity of the Underlying Assets Presents a Significant Obstacle to the Division's Valuation Claims

The assets held in the Funds are illiquid and are considered Level 3 assets under accounting principles generally recognized in the United States ("GAAP"). Level 3 assets are instruments for which "there rarely are observable market prices" because they "are not frequently bought or sold." *Home Loan Servicing Sols.*, SEC Release No. 3713, 2015 WL 5782427, at *6 (Oct. 5, 2015). The valuation of such assets requires the exercise of the investment manager's discretion and judgment and allows for "a wide range of reasonable results."[53] Indeed, Accounting Standard Codification ("ASC") 820 "expressly contemplates that different models, based on different assumptions and the assignment of different weight to different inputs, may be used to determine fair value." *Lehman Bros.*, 799 F. Supp. 2d at 312; *see also SEC v. Shanahan*, 646 F.3d 536, 540 (8th Cir. 2011) (affirming grant of motion for judgment on scheme liability claim where SEC failed to show that respondent had "failed to follow [an] accepted accounting principle").

Furthermore, Respondents disclosed to investors the inherently subjective nature of the Funds' valuation processes.[54] *See Allied Capital*, 2003 WL 1964184, at *5 (ruling that "no reasonable investor" could consider material the fact that certain of the defendant's assets "might have valuations that were debatable," when defendant had "fully disclosed that it determined the value of each investment using . . . a process that any reasonable investor would understand was somewhat subjective, involved judgment calls, and, given the lack of a market, would not yield exact, verifiable results").

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53. *Owens v. Jastrow*, 789 F.3d 529, 541 (5th Cir. 2015); *see also, e.g.*, *In re Lehman Bros. Sec. & ERISA Litig.*, 799 F. Supp. 2d 258, 312 (S.D.N.Y. 2011) (valuation of Level 3 assets "a matter of judgment"); *In re Allied Cap. Corp. Sec. Litig.*, No. 02-cv-3812, 2003 WL 1964184, at *1 (S.D.N.Y. Apr. 25, 2003) ("[V]aluing [assets] for which no current market exists involves the exercise of judgment, and is inherently imprecise.").

54. *See* June 2013 Confidential Private Offering Memorandum, p. 19 ("[T]he General Partner is ultimately responsible for valuing the Partnership's portfolio. . . . [T]here are likely to be investments as to which current or reliable market price information is unavailable. In this event, the General Partner has discretion to determine the appropriate means of valuation."); 2013 Domestic Fund Audited Financial Statements, at 13-14 ("To the extent that valuation is based on models or inputs that are less observable or unobservable in the market, the determination of fair value requires more judgment. . . . Because of the inherent uncertainty of valuation, those estimated values may be materially higher or lower than the values that would have been used had a ready market for the investments existed."); *see also* Ex. 2396, Metzger Report, at ¶ 122.

In such circumstances, the Division cannot establish scheme liability merely by second-guessing isolated instances where Respondents exercised discretion in the regular course of their valuation process.[55] The mere fact that the Division might prefer the use of different assumptions or inputs does not mean that Respondents' valuation methods violated ASC 820 or that the resulting valuations were unreasonable. *Lehman Bros.*, 799 F. Supp. 2d at 312.[56]

2. Respondents' Valuation Methodology Was Robust

The evidence at trial—including the uncontroverted testimony of Respondents' experts[57]—will show that the valuation procedures Respondents employed were robust and complied with industry best practices. These procedures included the following safeguards:

- Respondents employed an independent, nationally-recognized third-party valuation agent, Pluris Valuation Advisors, LLC ("Pluris") to value the portfolio assets on a monthly basis, and Respondents marked the portfolio each month to the values the independent agent assigned;
- The independent auditor for the Funds, Marcum LLP ("Marcum"), reviewed and tested the valuation process for the Funds as part of its regular audit procedures, and the auditor found the Funds' valuation processes met appropriate standards;
- The independent auditor also had its own valuation expert review the model and analysis of the Funds' third-party valuation agent (Pluris Valuation Advisors, LLC) and found the valuations were reasonable;

55. *See Epirus Capital Mgmt., LLC v. Citigroup Inc.*, 2010 WL 1779348, at *6 (S.D.N.Y. Apr. 29, 2010) ("Essentially, plaintiffs simply disagree with defendants' valuation methods, which does not equate to alleging fraud."); *Allied Capital*, 2003 WL 1964184, at *4 ("[G]iven the difficulty of valuing illiquid securities, and the multitude of factors that may appropriately be taken into account, alleging disagreement with [certain] valuations does not equate to alleging fraud."); *cf. Tongue v. Sanofi*, 816 F.3d 199, 214 (2d Cir. 2016) ("At bottom, Plaintiffs' allegations regarding Defendants' stated opinion about [particular] results are little more than a dispute about the proper interpretation of data, a dispute this Court [has] rejected as a basis for liability."). *See generally* Ex. 2396, Metzger Report , at ¶ 121 & n.68.

56. See *Yu v. State St. Corp.*, 686 F. Supp. 2d 369, 379-80 (S.D.N.Y. 2010) ("[I]f the stated valuations complied with the disclosed methods, they would not be actionable as 'false or misleading,' because they would correspond to the value that the offering documents led investors to expect."), *leave to replead granted*, 2010 WL 2816259 (S.D.N.Y. July 14, 2010).

57. *See generally* Ex. 2393, Martin Report, at ¶¶ 50–74; Ex. 2396, Metzger Report, at ¶¶ 117–37.

- Respondents engaged independent outside legal counsel to analyze various receivables in the portfolio to confirm both the expected likelihood and the timing of payout on those receivables in support of the valuation process.

Moreover, a large percentage of the Funds' assets have now collected at the values they had been assigned, or even greater, providing further proof that the assumptions made to value those assets were not only "reasonable" but highly accurate.

3. Respondents' Valuation Inputs Were Independently Analyzed

While the Division suggests in the OIP that Respondents somehow manipulated the inputs into their valuation process in order to inflate the reported value of their assets, it has failed to develop any evidence in support of this allegation. To the contrary, the evidence at trial will show that Pluris relied on independent experts even as to these inputs.

Respondents enlisted several independent legal due diligence advisors to conduct legal and risk reviews of selected receivables—including those arising from the *Peterson* litigation.[58] At the origination stage, Respondents engaged one outside law firm to perform an enhanced risk review of any position greater than $500K.[59] From 2007 through 2014, in conjunction with the Wiss & Company accounting firm ("Wiss"), a second outside law firm performed quarterly audits of selected delinquent assets; Wiss then included status updates of these assets in its quarterly "Agreed-Upon Procedures" reports, which Respondents made available to investors.[60]

In addition, in connection with the *Peterson* receivables, Respondents engaged outside counsel from the law firm Reed Smith to perform extensive analysis of the strength of the

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58. *See* Ex. 2393, Martin Report, at ¶¶ 54 & n.14, 67, 71 & n.30.

59. *See* Ex. 2393, Martin Report, at ¶ 71 n. 30. This enhanced review is in addition to the standard internal review performed on all prospective receivables by Respondents' inside counsel. *Id.*

60. *See* Ex. 2393, Martin Report, at ¶¶ 54, 67 & nn.27-28 (citing "Agreed-Upon Procedures" report for the third quarter of 2013).

Peterson plaintiffs' claims, which that firm captured over a span of more than a year and a half in several detailed memoranda submitted to Respondents and made available to Pluris.[61] Similarly, Respondents utilized outside counsel from another third-party law firm, Smith Mazure, to evaluate and monitor the strength and status of certain case inventories, including the case inventory that served as collateral for receivables from the Osborn firm, which the Division refers to in the OIP as "Law Firm A." As one of Respondents' experts explained, these independent law firms evaluated the receivables to help determine the likelihood and timing of payout on the receivables, which are key factors in determining the discount rate used to value Level 3 assets.[62] This process resulted in different valuations based on the specifics of the particular receivable.[63]

4. Unrebutted Expert Testimony Confirms that Respondents' Valuation Process Was Sound

Respondents' experts provide unrebutted testimony that the valuation procedures Respondents followed met all industry standards for Level 3 assets and that the values assigned to the portfolio assets were reasonable and accurate. The Division's response to these experts is silence. The Division has not offered any expert to address the reasonableness of Respondents' valuation methodology, and such testimony would not be within the scope of knowledge of any percipient witness in the case.

As expert David Martin explains in his report, Respondents' valuation methodology was compliant with ASC 820 and the requirement that fair value of the assets be determined

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61. *See* Ex. 2393, Martin Report, at ¶ 54 & n.14 (citing memoranda dated Aug. 17, 2012; May 8, 2013; and March 3, 2014).

62. Ex. 2393, Martin Report, at ¶¶ 17, 54.

63. *See, e.g.*, Ex. 1898, January 2014 Pluris Valuation Report (assigning differing "Base Yield" values to different classes of *Peterson* receivables); Ex. 2393, Martin Report, at ¶ 17.

according to the "exchange price" notion.[64] Martin's expert report confirms that Respondents' valuation model met these requirements and took into account individualized receivable discount rates that reflected non-performance risk related to timing and the nature of the underlying litigation, including likelihood of success.[65]

Respondents' valuation procedures also conformed to the valuation principles promulgated by the International Association of Financial Engineers ("IAFE"). Indeed, expert Leon Metzger, one of the principal authors of the IAFE standards, explains in his report that Respondents' procedures aligned with all applicable IAFE principles, including that valuation be performed in good faith, that all investors be treated equitably, and that valuation be performed in accordance with a disclosed valuation policy.[66]

5. History Has Vindicated the Reasonableness and Accuracy of the Respondents' Valuations

There is additional, and particularly stubborn, evidence that Respondents did not make "unreasonable assumptions" in connection with the valuation of the assets in the Funds—namely, that the valuations have been proven accurate. For example, by September 2016, both the Fay Kaplan Law Firm and the Perles Law Firm—whose positions with the Funds represented more than 60% of the entire *Peterson* positions held in the Funds as of April 2016—completed the repayment of their full balances owed to the Funds. The repayments were made at amounts above the independent valuations of those receivables provided by Pluris and as assigned by

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64. Ex. 2393, Martin Report, at ¶ 64.

65. *Id.* ¶ 67.

66. *See* Ex. 2396, Metzger Report, at ¶ 134.

Respondents.[67] In other words, the largest *Peterson*-related positions paid out *in excess* of their most recent valuations.

In addition, the Trustee of the *Peterson* Qualified Settlement Fund began the distribution of monies to *Peterson* plaintiffs on October 19, 2016, and approved an initial distribution to *Peterson* attorneys on November 24, 2016—thereby validating Respondents' confidence that the primary risk to both classes of *Peterson* positions was duration risk rather than credit risk.[68] To date, more than $1 billion dollars has been distributed from the trust.

B. Respondents Did Not Act with Intent to Deceive or with Extreme Recklessness in the Valuation of Fund Assets

To successfully bring a claim for scheme liability under Section 17(a)(1) or Rule 10b-5, the Division must prove that Respondents acted with scienter: that is, either with "an intention to deceive, manipulate, or defraud" or with "a high degree of recklessness." *Flannery*, 810 F.3d at 9. As explained above, the ultimate criterion in determining scienter "is whether the defendant knew his or her statements were false, or was consciously reckless as to their truth or falsity." *Gebhart v. SEC*, 595 F.3d 1034,1042 (9th Cir. 2010).

Here, fact and expert discovery has not revealed any document or testimony suggesting that Respondents consciously sought to deceive anyone, or were in any way reckless, regarding the value of Fund assets. In fact, the opposite is true: the evidence at trial will show that Respondents at all times exercised an appropriate standard of care in their valuation of the assets, relying on third-party professionals to perform and audit the valuation process and ensuring that the mechanisms and results of the process were transparent to Fund investors.

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67. *See* Ex. 2393, Martin Report, at ¶¶ 26, 56 & Exs. 6, 10.

68. *See* Letter addressed to Judge Katherine B. Forrest from Shalom Jacob, Attorney for Fund Trustee Retired Judge Stanley Sporkin, re: Update on Status of Distributions at 1, 6, *Peterson v. Islamic Republic of Iran*, No. 10 Civ. 4518 (K8F) (S.D.N.Y. Jan. 13, 2017), ECF No. 704.

The Division cannot, and does not, dispute Respondents' use of an experienced third-party valuation agent to model the fair value of the Funds' assets based on an external valuation methodology. *See* OIP ¶ 61. The Division does not allege that Respondents ever deviated from the valuation agent's recommendations. Nor does the Division dispute that Respondents relied on an external auditor to review the valuation results and methodology on an annual basis. All of these undisputed facts strongly suggest that Respondents did not act with scienter. *See, e.g.*, *Owens v. Jastrow*, 789 F.3d 529, 543 (5th Cir. 2015) (reliance on valuation model "does not lead to a strong inference of scienter").

Significantly, the Division has adduced no evidence that the results of Pluris' valuation model, as faithfully adopted by Respondents and confirmed as reasonable by expert testimony, were at all out of keeping with the appropriate fair value accounting for Level 3 assets, let alone in a way that would suggest conscious intent to deceive or extreme recklessness. *See Owens*, 789 F.3d at 543 (more difficult to infer scienter "when GAAP permits a range of acceptable outcomes"); *Fin. Acquisition Partners LP v. Blackwell*, 440 F.3d 278, 290 (5th Cir. 2006) ("[F]ailure to follow accounting standards, without more, does not establish scienter.") To prevail on its scienter-based claims, the Division must prove not only that the valuations were incorrect, but that Respondents either consciously sought to deceive through the allegedly incorrect valuations or were "consciously reckless as to their truth or falsity." *Gebhart*, 595 F.3d at 1042. It cannot do so here—the valuations were both correct and arrived at in good faith.

CONCLUSION

For the reasons stated above, the Division will not be able to meet its burden of proving the charges set forth in the OIP. Accordingly, Respondents respectfully request a ruling in their favor on all charges in this matter.

Dated: March 8, 2017

Respectfully submitted,

Terence Healy\WSJ

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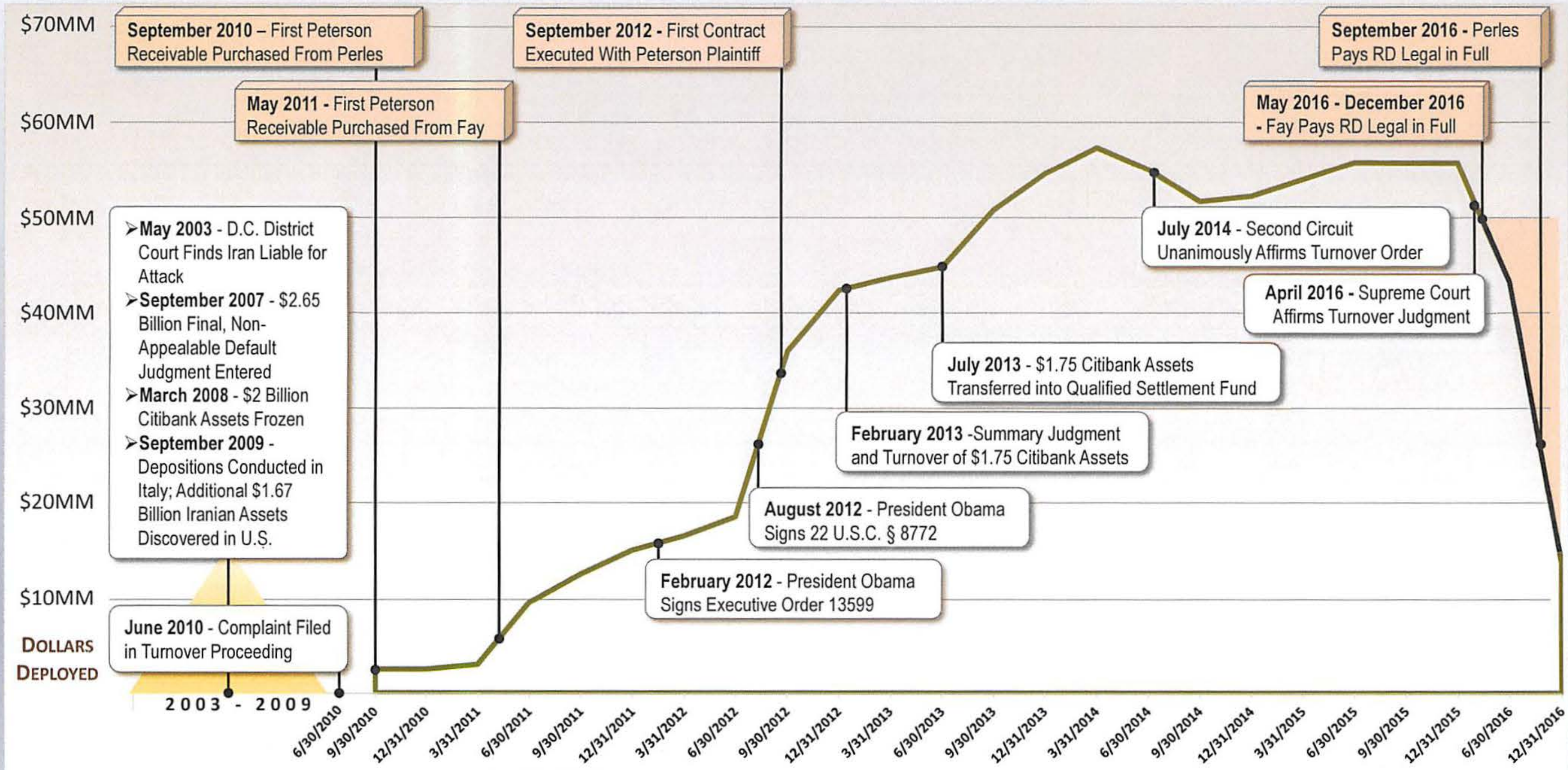
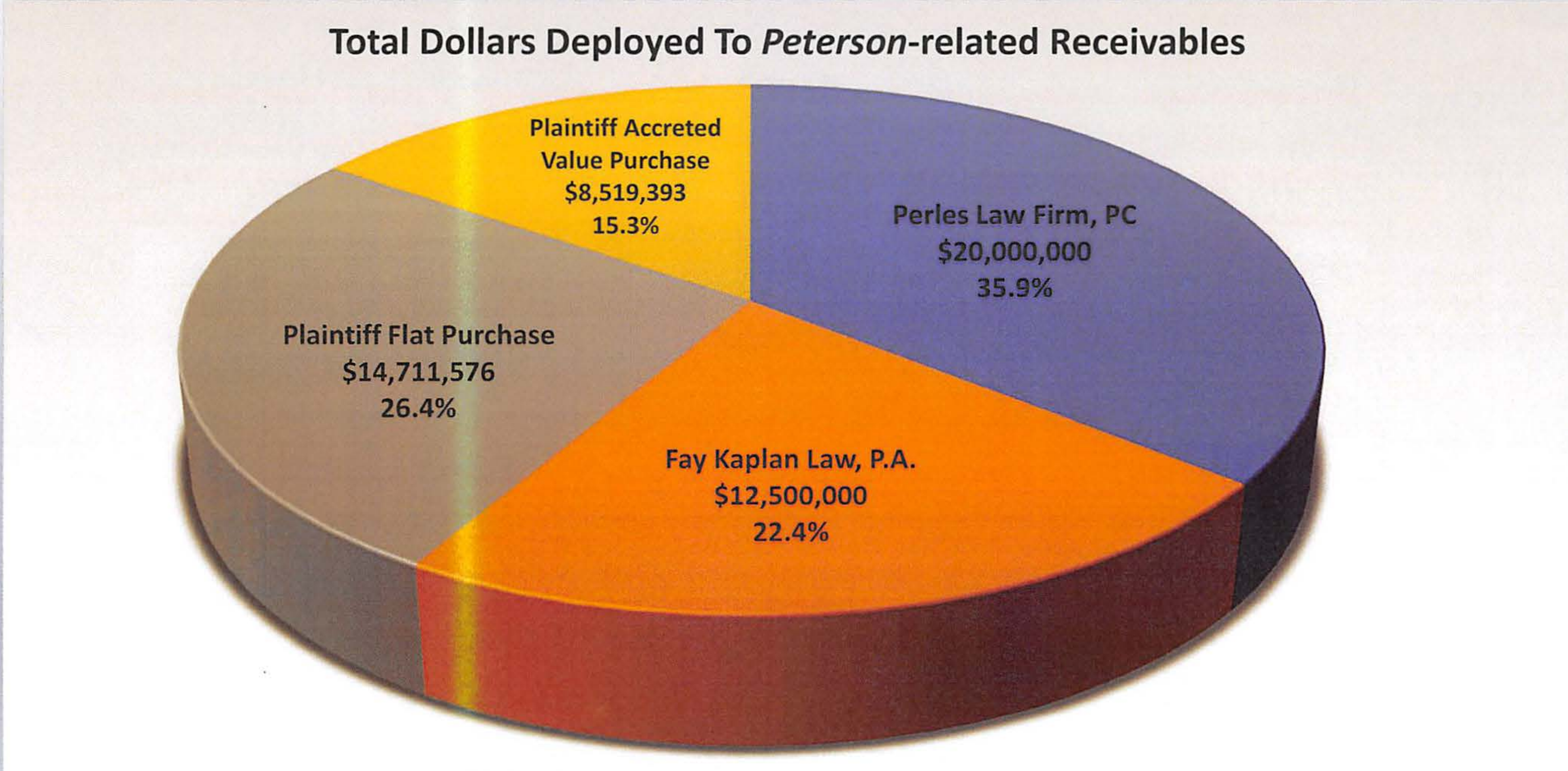
Tab A

PETERSON – RELATED RECEIVABLES AND CORRESPONDING CASE DEVELOPMENTS



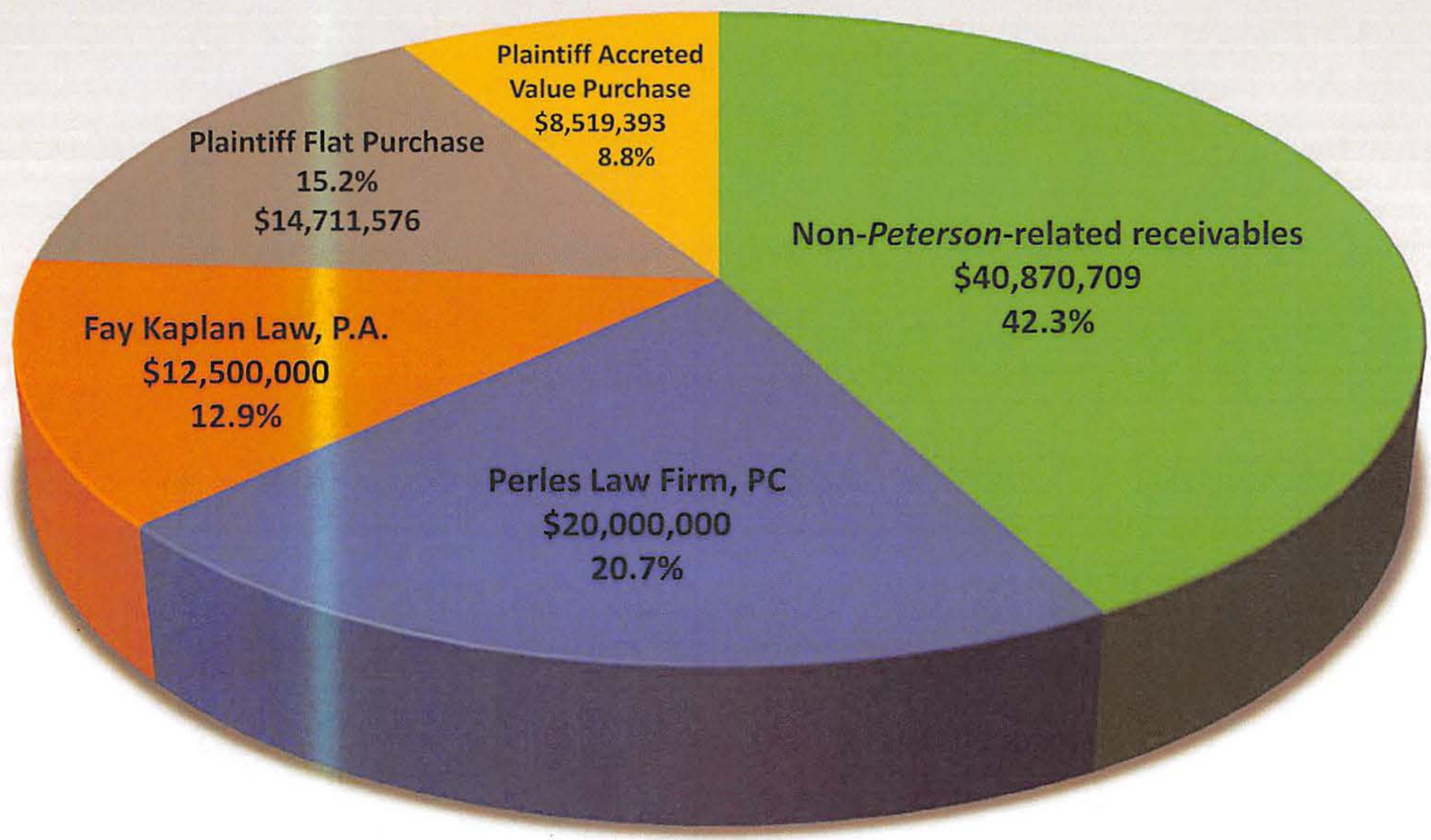
Tab B

DIVERSIFICATION OF *PETERSON*-RELATED RECEIVABLES (AS OF 12/31/15)



DIVERSIFICATION OF *PETERSON*-RELATED RECEIVABLES (AS OF 12/31/15)

Diversification of *Peterson*-related Receivables Across Entire Portfolio By Dollars Deployed (as of 12/31/15)



CERTIFICATE OF SERVICE

The undersigned certifies that the foregoing Pretrial Brief of RD Legal Capital, LLC and Roni Dersovitz was served on this 8th day of March 2017 by U.S. Postal Service on the Office of the Secretary and by electronic mail on the following counsel of record:

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